Supreme Court, U.S.
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No. 03-535

IN THE

Supreme Court of the United States

INDU CRAFT, INC.,

Petitioner,

v.

BANK OF BARODA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF

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STATEMENT PURSUANT TO RULE 29.6

Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

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Petitioner Indu Craft, Inc. respectfully submits this reply memorandum in further support of its petition for a writ of certiorari to review the mandate of the United States Court of Appeals for the Second Circuit.

Respondent Baroda urges this Court not to grant the certiorari because it maintains there is no compelling public reason for the Court to do so and that the Court cannot cure a wrong done to one private litigant and the integrity of certiorari process will be jeopardized. To the contrary, (1) there is a major conflict among circuits with respect to the application of the provisions of the Bankruptcy Code involved in our case – Section 524(e) – with respect to whether this section applies to non-debtors and tortfeasors and (2) Second Circuit allowed a third party to use debtor's discharge as a defense against debtor's claim in violation of the Bankruptcy Code and this Court's rulings, which hold that discharge is a debtor's personal defense.

I. Baroda's Assertion Of Indu Craft's Discharge Of Trendi's Claim As A Bar To Its Derivative Liability Is Prohibited By Section 524(e)

A. Baroda May Not Assert Indu Craft's Discharge As A Defense To Its Derivative Liability

Baroda argues that it has not relied upon nor asserted the benefit of section 524(e). *See* Bank of Baroda Brief in Opposition at 12. This argument, however, seeks to obscure the fact that the basis of Baroda's motion to dismiss was predicated on its contention that bankruptcy judgment was void under section 524(a) of Bankruptcy Code because it had been discharged by Indu Craft's Plan. Baroda argued that by virtue of "the effect of such discharge under Bankruptcy Code" a derivative claim could not be asserted against it because "Indu Craft has not suffered, and cannot suffer, any loss or damage resulting from the Trendi Judgment, [1] which is void." *See* Bank of Baroda's Memorandum of Law in Support of Motion to Dismiss First

1. In its opposition papers, Baroda mischaracterizes Trendi as Indu Craft's "affiliate." Trendi has never had any interest in Indu Craft, whose sole shareholder is Tze Wung Consultant, Ltd. *See* Brief in Opposition, App. 2a. Moreover, Indu Craft has never had any financial interest in Trendi. During the 1980's, the companies had a common principal stockholder.

Amended Fourth-Party Complaint at 13-14.[2] There can be no question that in obtaining dismissal of Indu Craft's amended fourth-party complaint, Baroda was seeking and, in fact, obtained the benefit of Indu Craft's discharge under Bankruptcy Code. Section 524(e) was written precisely to combat this argument by a derivatively liable non-debtor and to prevent the result reached by the courts below.

Section 524(a) of Bankruptcy Code codifies what has long been settled that a discharge is personal to the debtor and cannot be used to benefit third parties. 11 U.S.C. § 524(a). Accordingly, the statutory language, on its face, does not preclude the determination of the debtor's liability upon which the damages would be owed by another party. *Moyer v. Dewey*, 103 U.S. 301, 302-03 26 L. Ed. 394 (1880) ("Under these circumstances, we concur with the opinion of the Court of Appeals, that so far as the discharge itself is concerned, its only effect is personal to him, and does not avail to release the defendants in this suit from liability for the fraud committed by them"); *In re Jet Florida Systems, Inc.*, 883 F.2d 970, 973 (11th Cir. 1989) (same); *In re Glen-Bern Industries, Inc.*, 1 Bankr. Ct. Dec. (CRR) 1356, 6 Collier Bankr. Cas. (MB) 100, 102 (Bankr. D. Mass. 1975) (although decided under § 16 of the Bankruptcy Act of 1898, the court reasoned that a discharge is personal to the debtor and does not accrue to the benefit of third parties who may have liability based on the bankrupt's liability). Because discharge of the Trendi debt was the personal liability of Indu Craft, Baroda lacked judicial standing to plead Indu Craft's discharge as a defense in the District Court action or move against the amended fourth-party complaint on that basis.[3]

2. Indu Craft did in fact suffer a loss by assigning its right to the proceeds of its derivative claim against Baroda to its creditors in exchange for their votes in favor of confirmation of its Plan and subsequent discharge.

3. Baroda argues that Indu Craft did not raise in the courts below its argument that Baroda lacked legal standing to assert Indu Craft's discharge as a defense in the District Court. An issue with respect to a party's standing is not subject to waiver and this Court can consider the issue even if not addressed by the courts below. *City of Redmond v. Robinson*, 517 U.S. 1201, 1201, 116 S. Ct. 1702, 134 L. Ed. 2d 801 (1996) (Rehnquist, J., Scalia, J. and Thomas, J., dissenting). Moreover, Indu Craft's standing argument is predicated on Baroda's collateral attack on the Plan in the District Court which was considered by the courts below.

What the courts below failed to recognize is that a discharge in bankruptcy does not extinguish the debt itself but merely releases the debtor from personal liability which, by virtue of section of 524(a)(2), bars its enforcement against him. The debt still exists, however, and can be collected from any other entity that might be liable. *In re Lembke*, 93 B.R. 701, 702 (Bankr. D.N.D. 1988). In other words, "[w]here a claim is discharged, the debt is recognized in bankruptcy – that is, allowed – but the debtor is relieved of responsibility for it. Because this relief is limited to the debtor, a party derivatively liable for the debt, such as an insurer, remains responsible." *Bursch v. Beardsley & Piper, Div. of Pettibone Corp.*, 971 F.2d 108, 114 (8th Cir. 1992). Congress promulgated 524(e) to insure that a derivatively liable defendant cannot assert as a defense to its own liability for the debt, the debtor's discharge of it legal obligation to pay the debt.

The critical fact relied upon by the courts below in dismissing the amended fourth party complaint – that Indu Craft did not have to pay the bankruptcy judgment[4] – does not give rise to a defense to the assertion of an indemnification claim by the debtor against its indemnitor.[5]

4. Baroda attempts to argue that the bankruptcy judgment is collusive. A large part of the bankruptcy judgment is interest from 1987, when actions were taken by Baroda which caused the destruction of Indu Craft's business. Trendi submitted twelve volumes of purchase orders and actual sales documents in the proceeding before the Bankruptcy Court fixing its claim against Indu Craft as well as proof of the value of its business through expert affidavits. Trendi was initially attempting to prove a claim in the amount of $29,490,290 or, alternatively $25,201,120. Indu Craft objected to Trendi's claim and argued that the Trendi's claim should be allowed in the amount of $20,480,275.04. Trendi ultimately agreed to a reduction in its provable damages in supplemental submissions to the Bankruptcy Court. A bankruptcy court has the power and obligation to inquire into the validity of any claim and disallow if determined to be improper in any way. *Pepper v. Litton*, 308 U.S. 295, 305-306, 60 S. Ct. 238, 84 L. Ed. 281 (1939). It is thus patently improper to argue in its opposition brief that the bankruptcy judgment is collusive. The courts below have made no such finding and Baroda did not predicate its motion to dismiss on this basis. Moreover, Indu Craft was entitled to have all inferences drawn in its favor on Baroda's pre-answer motion to dismiss.

5. Indu Craft argued in the courts below that the bankruptcy judgment was excepted from discharge because its entry against the debtor was (Cont'd)

It is elementary that a discharge releases the debtor from any legal duty to repay the debt. *Campbell v. General Financing Corp. of Virginia*, 523 F. Supp. 989 (W.D. Va. 1981). Notwithstanding, section 524(e) commands that the liability of a non-debtor is not affected by the discharge of the debtor's legal obligation for the debt. The courts below clearly erred in holding that because Indu Craft "was discharged from its obligation to pay the judgment entered against it in the bankruptcy proceeding," Baroda could not be held derivatively liable for the judgment. *See* Petition, App. 25a.

Numerous cases have held that section 524(e) bars an insurer from raising the debtor's discharge and inability to pay as a defense to a claim by an injured party through the debtor under the debtor's insurance policy. *Green v. Welsh*, 956 F.2d 30, 33 (2d Cir. 1992) (collecting cases); *Bowers v. American Surety Co.*, 30 F.2d 244, 245 (2d Cir.), *cert. denied*, 279 U.S. 865, 49 S. Ct. 480, 73 L. Ed. 1003 (1929); *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985).[6] The reasoning of the insurance cases is that the case can proceed against the debtor for the purpose of obtaining a judgment against the debtor so long as the debtor does not have to pay the judgment for the purpose of getting the debtor's indemnitor to pay the judgment. As the *Lembke* court noted, "[i]t makes no sense legally or equitably for an insurer to escape insurance coverage for injuries caused by its insured merely by the happenstance of the insured's bankruptcy discharge. Such a result would be fundamentally wrong." 93 B.R. at 702.

(Cont'd)

authorized by the Plan and, moreover, section 9.1(c) of the Plan expressly excepted judgments of the Bankruptcy Court from discharge. But even assuming that Indu Craft was discharged from having to pay the bankruptcy judgment, as determined by the courts below, this fact does not prevent the assertion of an indemnification claim by the debtor as demonstrated herein.

6. To the extent that Baroda argues that section 524(e) is limited to guarantors and co-obligors, such an argument is plainly contrary to the statutory language and legislative history. *Green*, 956 F.2d at 33 n.1; *In re Mann*, 58 B.R. 953, 956 n.4 (Bankr. W.D. Va. 1986); *see also* 4 William M. Collier et al., *Collier on Bankruptcy* ¶524.05 (2002 ed.) ("Hence it has been repeatedly held that the discharge has no effect on a nondebtor, codebtor or guarantor of the discharged debt").

The imposition of the payment rule imposed by the courts below as a condition to the prosecution of Indu Craft's suit against Baroda as Indu Craft's indemnitor cannot be squared with this reasoning or the legislative history of section 524. If an insurer may be held derivatively liable to the debtor despite the discharge of the debtor's liability to the injured party, then there is no analytical difference why Baroda cannot be held derivatively liable to Indu Craft for the debt owed to Trendi as the result of Baroda's tortious conduct. In short, if Indu Craft is entitled to be indemnified by Baroda, then the derivative suit should have not been dismissed by the District Court and Baroda was prohibited from asserting Indu Craft's discharge and consequent release of any duty to pay the bankruptcy judgment as a defense to its derivative liability. *Healey v. Scovone*, No. 98-2285, 1999 U.S. App. LEXIS 17385 (10th Cir. 1999) (action could proceed against debtor and debtor' indemnitor if debtor is entitled to indemnification).[7]

It would be similarly fundamentally wrong to allow Baroda to ride the coattails of Indu Craft's discharge and provide it with a windfall merely as the result of the happenstance of Indu Craft's bankruptcy. *See Lewis v. Manufacturers National Bank*, 364 U.S. 603, 609, 5 L. Ed. 2d 323, 81 S. Ct. 347 (1961). Indeed, section 1123(b) of Bankruptcy Code authorizes post-confirmation pursuit of a debtor's bankruptcy causes of action. As the court in *In re Acequia, Inc.*, 34 F.3d 800, 807-08 (9th Cir. 1994) aptly noted: "If the confirmation of a plan of reorganization . . . sufficed to eliminate [the debtor's] causes of action . . . , both section 1123(b)(3)(B) and the litigation-enabling provision of [the debtor's] plan would be pointless. . . . [a]nd . . . debtors would undoubtedly delay filing plans of reorganization until completing all potential litigation." Here, what makes the decisions of the courts below plainly wrong is that Indu Craft could have pursued its derivative claim against Baroda pre-confirmation and had it done so there would be no issue of discharge. It also nonsensical, and wrong as a matter of law, to bar Indu Craft

7. The District Court and Court of Appeals determined that Indu Craft's amended fourth party complaint set forth proper claims against Baroda for indemnification. *See* Petition, App. 24a.

from pursuing its derivative claim against Baroda post-confirmation where its Plan so provides. Section 524(e) flatly bars such a result.

B. Compelling Reasons Exist For Granting The Petition

The Court should not allow the courts' opinions in this case to stand as precedent in such an important area of bankruptcy law.[8] These decisions may be used as a basis to defeat any post-discharge claim for indemnification brought by a debtor. A determination by the Court that section 524(e) prohibits a derivatively liable party from asserting the debtor's release from its obligation to pay a judgment rendered against it as a defense to the derivative claim by the debtor will have applicability in every federal court and state court in the country in which an indemnification claim may be asserted by a debtor or by an injured party through the debtor.

Moreover, a determination by the Court that Baroda may not be advantaged by the discharge of the debtor in the context of a derivative claim fairly subsumes and, therefore, will resolve, the question under section 524(e), over which there is a substantial conflict among the circuit courts, whether, and under what circumstances, a bankruptcy court may release a non-party of claims based on the debtor's discharge. *See* Petition at 18-20.

Finally, this case should be reviewed by the Court because the courts below came to the untenable conclusion that confirmation of the Plan discharged the new payments in the form of allowed claims that the debtor promised to pay its creditors under the Plan. This holding taken to its logical conclusion would relieve debtors from their contractual obligations under confirmed plans post-confirmation at the moment of its discharge – contrary to the fundamental expectations of the debtor and its creditors in every reorganization proceeding.

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8. According to the American Bankruptcy Institute ("ABI"), there were 1,577,651 bankruptcy cases filed in the U.S. in 2002, 72,990 of which were filed in New York, or roughly 4.6% of the total filings. American Bankruptcy Institute (http://www.abiworld. org/stats/1980annual.html). Moreover, New York is the situs of many of the largest bankruptcy filings: Worldcom, Inc. ($103,914,000,000 assets), Enron ($63,392,000,000), Global Crossing Ltd ($30,185,000,000), Adelphia Communications ($21,499,000,000).

II. Section 524(e) Abrogates The Payment Rule Of State Indemnity Law

Baroda contends that Indu Craft failed to raise the question of whether 524(e) abrogates the common law indemnification payment rule. Indu Craft raised in both the district court and the court of appeals the issue of whether under section 524(e) Indu Craft's discharge and consequent release of its obligation to pay the bankruptcy judgment is a defense to the assertion of a derivative claim against Baroda. The central holding of the District Court's decision, which was adopted by the Court of Appeals, is that Indu Craft's discharge from having to make payment of the bankruptcy judgment prevented the assertion of a derivative claim against Baroda and that section 524(e) is inapplicable in preventing the assertion of such defense. In other words, the District Court held that the payment rule of common law indemnity trumps section 524(e)'s mandate that "the discharge of the debt of the debtor does not affect the liability of any other entity . . . for such debt."

In its reply brief in the court of appeals, Indu Craft argued precisely the point that it raised in its Petition, that "[s]ection 524(e) in effect abrogates the payment rule because on its face it prevents the insolvency of the debtor from being asserted as a defense by the derivatively liable defendant." *See* Reply Brief for Third-Party Defendant-Fourth-Party-Plaintiff-Appellant Indu Craft, Inc. at 6. The Court of Appeals considered and rejected this argument in reaching its decision. *See* Petition, App. 6a ("upon review of the record and consideration of all the arguments presented by the parties, we affirm the dismissal of the amended fourth-party complaint and the second third-party complaint largely for the reasons stated in the opinions of the District Court."). The preemption point raised in the Petition is a corollary of the abrogation point and is fairly subsumed within the holdings of the courts below that the payment rule of state indemnity law prevents the assertion of a derivative claim, notwithstanding section 524(e)'s bar against the assertion of the debtor's non-payment of the debt by a non-debtor indemnitor in a derivative action.

Preemption may be implied if state and federal laws conflict or a state law thwarts the "accomplishment and

execution" of congressional intent. *See Pacific Gas & Elec. Co. v. State Energy Resources Conservation & Dev. Comm'n*, 461 U.S. 190, 204, 103 S. Ct. 1713, 1722, 75 L. Ed. 2d 752 (1983); *Maryland v. Louisiana*, 451 U.S. 725, 747, 68 L. Ed. 2d 576, 101 S. Ct. 2114 [**56] (1981) (State law is void to the extent it is in conflict with a federal statute.); *Stellwagen v. Clum*, 245 U.S. 605, 613, 62 L. Ed. 507, 38 S. Ct. 215 (1918) (The provisions of the federal bankruptcy code preempt those state laws that are in conflict with federal law); *In re Nation*, 236 B.R. 150, 154 (Bankr. S.D.N.Y. 1999) ("National policy codified in a statute of Congress such as Bankruptcy Code must be given primacy over local enactments and private contracts"). Moreover, property interests, which are created and defined by state law, may be altered by Congress under its power to establish uniform laws throughout the United States. *See Butner v. United States*, 440 U.S. 48, 55, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979).

Section 524(e)'s abolition of the debtor's non-payment of a debt due to discharge as a defense by a derivatively liable defendant is in direct conflict with the New York State law of indemnity requiring payment of a judgment as a condition to the assertion of a derivative claim for indemnification. *See* Petition, App. 24a ("It is black letter law in New York that an indemnification claim does not arise until the party seeking indemnification has an out-of-pocket loss to be reimbursed"). In short, section 524(e) states that even though the debtor is relieved from paying a judgment, an action may be maintained against a derivatively liable defendant because the liability of any other entity is not affected. The payment rule states that no claim may be asserted against a derivatively liable defendant unless and until the judgment is paid. Accordingly, Indu Craft's discharge of its obligation to pay the bankruptcy judgment cannot stand as a bar to its assertion of a derivative claim against Baroda. The promulgation of section 524(e) represents Congress' alteration of state property rights by its clear intention of removing the debtor's inability to pay a debt as a bar to the debtor pursuing an indemnity claim against its indemnitor.

A determination by the Court that section 524(e) preempts the common law indemnity rule of many states, including New

York, requiring payment as a condition to the assertion of the claim will have widespread effect and importance. Debtors are often in the position where they may have to assert indemnity claims against third parties since such claims constitute property of the debtor's estate. A clear rule established by this Court that a debtor may prosecute its indemnity claims even though it has been discharged of its legal obligation for the debt will advance the twin goals of Bankruptcy, which are providing the debtor with a fresh start and maximizing the distribution of the debtor's property to its creditors. *Precision Indus. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 548 (2003). The contrary precedent established by the courts below should not stand because it improperly construed Bankruptcy Code as preventing the debtor from pursuing an indemnity claim as property of its estate for the benefit of its creditors.[9]

III. Since The District Court Held That The Act Of Confirmation Prevented Payment Of The Plan's Allowed Claims, Its Holding Necessarily Undermined The Feasibility Finding Of The Bankruptcy Court

The confirmation process in a Chapter 11 case is primarily an inquiry into the viability of the proposed plan and the disposition of the debtor's assets." *Kaiser Aerospace & Elec. Corp. v. Teledyne Indus. (In re Piper A.)*, 244 F.3d 1289, 1299 (11th Cir. 2001), *cert. denied*, 534 U.S. 827 (2001). Baroda's contention in its opposition brief that its motion did not represent a collateral attack on the Plan because Indu Craft stated in its Disclosure Statement that the Plan was feasible is pure sophistry. The statement of feasibility contained in the Disclosure Statement was predicated upon a Plan that had as its central component the payment of the allowed claims of Indu Craft's class 5 creditors through the prosecution of Indu Craft's derivative claim against Baroda. Indu Craft's creditors had the right to receive payment of their allowed claims from the net proceeds of the prosecution of Indu Craft's derivative claim against Baroda.

The District Court and Court of Appeals held in this case that it was the act of confirmation of Indu Craft's Plan that

9. Indu Craft's derivative claim against Baroda constituted approximately 90% of the value of all of its property.

caused Indu Craft to lose its derivative claim against Baroda. If the act of confirmation caused Indu Craft to lose its derivative claim, then the Plan was not feasible because the same act of confirmation made it impossible for Indu Craft's class 5 creditors to obtain payment of their allowed claims. There was no probability at all that the Plan provisions could be performed if confirmation was the *sine qua non* that prevented payment of the allowed claims and the loss of the derivative claim. It is ironic that the Plan could not have been confirmed without the affirmative vote of Indu Craft's class 5 creditors under 11 U.S.C. § 1126(f) (since all other classes of creditors received payment of their claims), and yet under the District Court's analysis it was their vote for confirmation of the Plan that made payment of their allowed claims impossible.

Thus, the District Court's holding that the derivative claim was lost through confirmation of the Plan destroyed the feasibility finding made by Bankruptcy Court and overturned Indu Craft's final and unappealable Plan. Baroda's motion, therefore, can only be viewed as a collateral attack on the Plan because the essence of the motion was its contention that as a result of the discharge of Trendi's claim resulting from confirmation of the Plan, the Plan provisions requiring payment of allowed claims from the proceeds of Indu Craft's derivative claim against Baroda could not be accomplished.

The successful collateral attack by Baroda on Indu Craft's plan violates *Celotex Corporation v. Edwards*, 514 U.S. 300 (1995) because Baroda has for all intents and purposes effectuated a reversal of the Plan outside of Bankruptcy rules and procedures for appellate review. *See also Bell v. Eastman Kodak Co.*, 214 F.3d 798, 801 (7th Cir. 2000). The District Court in this instance was not sitting as a bankruptcy appellate court and it was precluded from reversing the order of confirmation of Indu Craft's Plan by holding that confirmation of the Plan and the resultant discharge caused the loss of Indu Craft's derivative claim and prevented payment of the allowed claims.

CONCLUSION

For the foregoing reasons, Indu Craft's Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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